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of Payment Card Rewards Over?**

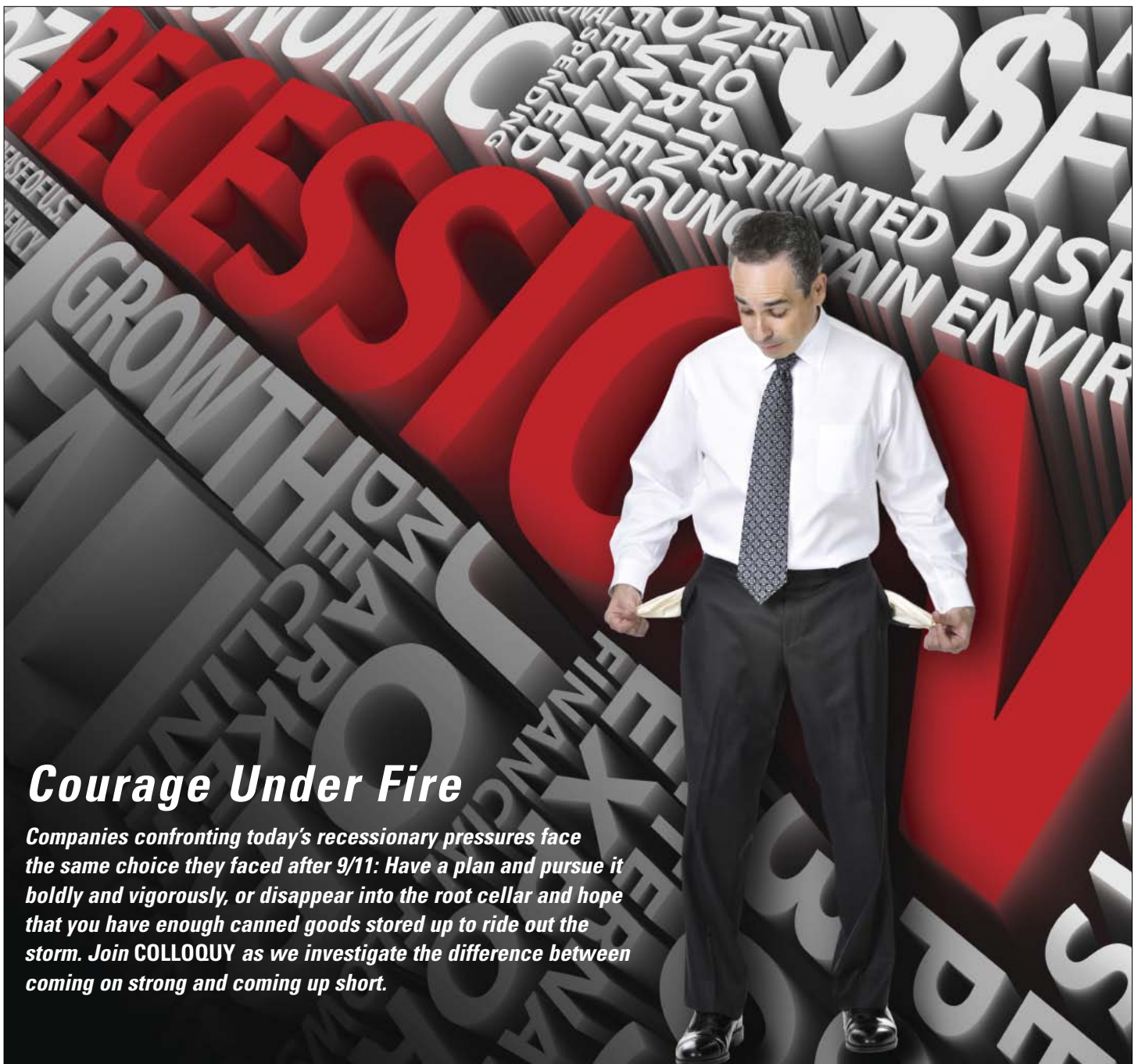
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Courage Under Fire

Companies confronting today's recessionary pressures face the same choice they faced after 9/11: Have a plan and pursue it boldly and vigorously, or disappear into the root cellar and hope that you have enough canned goods stored up to ride out the storm. Join COLLOQUY as we investigate the difference between coming on strong and coming up short.

FINANCIAL SERVICES REPORT

A Remembrance of Things Past

Is the Golden Age over, or will a new day dawn for payment card rewards?

BY RICK FERGUSON AND BILL HANIFIN



BANK MARKETING EXECUTIVES a little longer in the tooth may recall what an unprecedented success was the GM MasterCard launch in September, 1992. The first modern co-branded rewards credit card, The GM card launch set a then-industry record by opening one million new accounts and an estimated \$60 million to \$100 million in charges in its first month. The success prompted COLLOQUY, in its Summer 1995 issue, to declare that “co-branded cards are here to stay.”



Such is the nature of under-predicting a future trend. Today, payment cards topped with rewards

are as familiar to consumers as a hot dog topped with mustard. A Packaged Facts report estimates that rewards cards account for 80 percent of all general-purpose credit cards issued in the United States. First Data, meanwhile, estimates that 25 percent of all debit cards carry rewards schemes. COLLOQUY’s own 2009 Loyalty Census estimates 422 million members of U.S. financial services loyalty programs, representing a 77 percent growth in memberships since our last count in 2006.

So successful and necessary have rewards payment cards become to cardholder acquisition, retention

and usage that it’s safe to say that, in the past 17 years, we’ve been living through the Golden Age of financial services rewards programs. But since we’re also currently living through the implosion of the financial sector that began with the collapse of Lehman Brothers in September 2008, it’s equally safe to ask: Is the Golden Age of payment card rewards now over?

“Although we’re in a very challenging period, Citi remains committed to rewards as an important strategy for loyalty,” says Nancy Gordon, Executive Vice President for Citi’s *ThankYou Rewards* program.

In reaction to this perfect storm of unprecedented market decline, deteriorating consumer credit and brutally high unemployment, it certainly appears as if banks are withdrawing into their bunkers. Not only are they trimming credit lines and canceling accounts, but they’re also diluting the value of rewards for their remaining cardholders. Is there fundamental change underway in the card rewards business? Will loyalty marketing continue to be a first-priority tactic for issuers? Will they preserve the goodies only for their high-spending elite cardholders—or will banks walk away from rewards programs altogether?

The jury, as they say, is still out. Here’s a look at the trends shaping the future of loyalty marketing in the financial services industry.

I. The end of easy money

There is no question that the era of easy consumer credit is over, at least for the short term. Banks have slashed credit lines overtly, by canceling your consumer or business card account outright, and stealthily, by slashing your credit line to a figure below your existing balance, making the card impossible to use. American Express made headlines by offering selected cardholders cash payments up to \$300 to pay off their balances and close their accounts. Meredith

Whitney, Wall Street bank analyst and former Managing Director at Oppenheimer, recently predicted that credit card lines will be cut by \$2.7 trillion, or 50 percent, by the end of 2010, and that issuers will trim acquisition programs, offering fewer Americans new cards. Okay, so acquisition is off the table. What about retention? Certainly with their record of proven profitability and high cardholder expectations, rewards cards would appear to be the perfect tool to retain those high-value cardholders who still have jobs.

But card issuers are nonetheless slashing program costs and make reward redemption more difficult, and the past few months have seen a corresponding deluge of bad press highlighting the changes. American Express stopped offering double miles for spending in gas, drug store, and supermarket categories on its Delta *SkyMiles* card. Citi now requires higher point values for redemption of domestic airline flights, may add a fee to redeem points on accounts with late payments, and now mandates that closed accounts forfeit accumulated point balances. JPMorgan has limited the spending categories from which customers receive cash back on Chase Freedom cards and reduced earnings for new cardholders to one point per dollar, down from the previous triple-point offer for spending in the cardholder's top three spending categories. Discover doubled the minimum redemption threshold on its Discover Miles card and ended its offer of 12,000 bonus airline miles for new cardholders. Capital One shelved its tiered airline rewards structure for a direct exchange of 100 miles for each dollar spent on travel rewards.

Banks have implemented these changes not because they now hate their customers, as rabble-rousers in the press would have you believe, but rather for reasons of simple economics. If they don't slash costs, they won't stay in business.

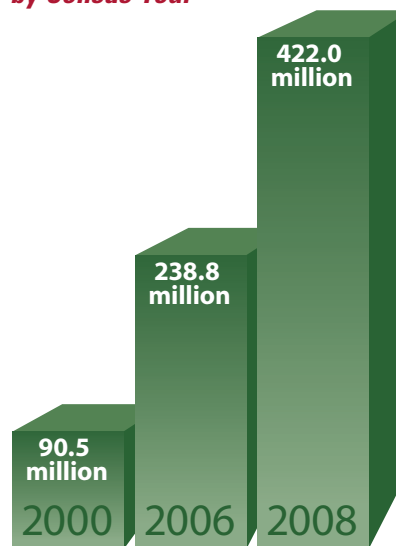
Discover Financial Services, for example, reported the net cost of its rewards program at \$710 million—nearly 12.5 percent of their total 2008 revenue of \$5.7 billion. Factor those numbers against bankcard delinquency rates that rose to 1.21 percent in the fourth quarter of 2008, up 11 percent over the previous quarter, and credit card charge-offs that could climb to near 10 percent this year, and those stingier rewards become a little more understandable. According to Moshe Orenbuch, an analyst at Credit Suisse, card issuers could suffer up to \$75 billion in losses during 2009.

At the same time, bankers have lots more to worry about than just reward costs and defaulting customers. Looming on the horizon is the Unfair and Deceptive Acts and Practices (UDAP) legislation, a set of new regulations that will further pressurize financial institution profitability as lost interest and fee revenue will be paired with increased risk-management challenges. UDAP carries the hidden cost of extensive system modifications for banks to comply with the new legislation. The ultimate financial impact of UDAP is still unquantified, and the uncertainty adds to the general climate of fear.

"Most banks are in a wait-and-see mode," says one industry executive. "Capital preservation is their highest priority."

Even with no end to the financial crisis in sight, no one is yet predicting the total demise of payment card reward programs. The richness of the rewards is tied directly to the revenue streams of each product: credit cards generate transaction and account usage fees as well as a net interest margin driven by revolving balances, while debit cards generate much lower but predictable streams from interchange fees. When the revenue returns, so will the rewards. In a recent investor presentation, JPMorgan Chase reported that their cobranded cards outperformed their

Exhibit 1: U.S. Financial Services Loyalty Program Memberships by Census Year



Source: 2009 COLLOQUY Loyalty Census

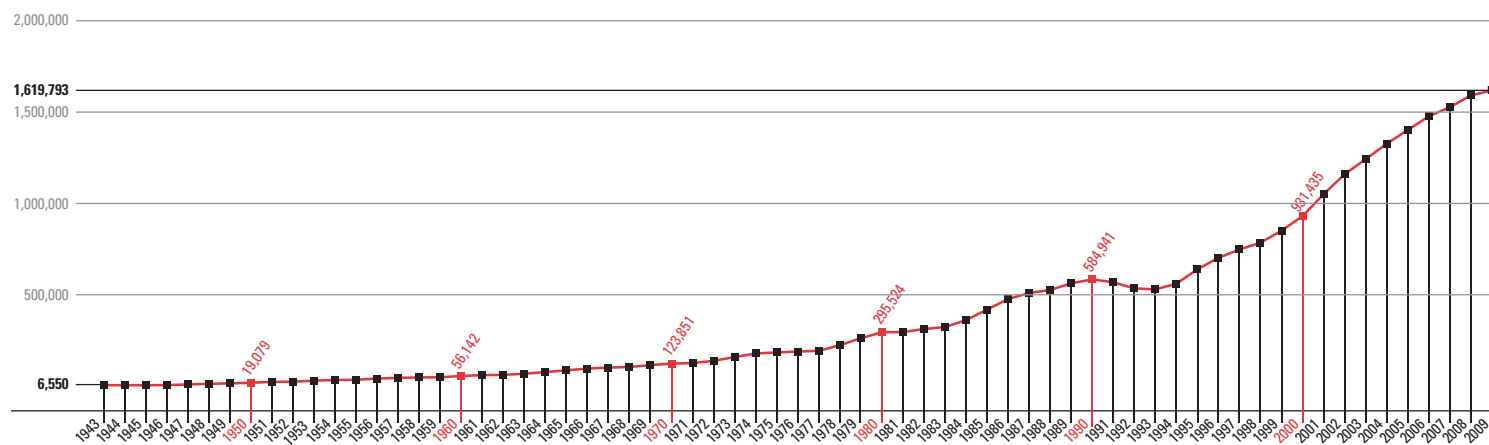
native Chase brand cards with 50 percent higher three-year average, risk-adjusted revenue. With a 2006 Visa study revealing that rewards cards account for 77 percent of all purchases, it seems clear that card rewards are not only here to stay, but will be a continuing emphasis of major card issuers.

"Rewards payment cards will continue to be important," says John Owens, Senior Vice President of Cobranded Relationships at US Bank. "But the focus of the currency will change with the times."

II. The end of consumer profligacy

Tighter risk-management policies combined with the myriad of new tweaks to existing rewards programs are leading consumers to evaluate their usage of payment products. But will consumers react to the credit crunch as they have to see-sawing fuel prices? Will we all lock our credit cards in a drawer the way we parked our SUVs when gas prices skyrocketed? And more importantly, just as we were once again lured by the siren song of our V-8 engines once gas prices softened, will we likewise dust off our credit cards when good times return?

Exhibit 2 U.S. Consumer Credit Debt, 1943 to Present



Dates indicate January of each year. Numbers are reported in millions.
Source: The Federal Reserve consumer credit statistical releases

Maybe not, says Nancy Gordon, who suggests that we may be witnessing a more permanent set of changes in consumer behavior.

"I think it's too soon to tell, but my personal perspective would be that there is going to be a complete market reset," says Gordon. "We have the data to see how customers continue to use their cards. But I suspect that there's a fundamental transformation underway."

"We need to go back to a period of higher savings and de-leverage the household or we're all in trouble," says Dan Marks, Chief Marketing Officer for First Tennessee Bank. "It's a pretty safe bet that it's permanent for a while."

With these fundamental changes underway, card issuers hope to reign in losses and bolster profitability without damaging their brands. Noting the decline in consumer spending and card charge volume, the front-runners will exploit the move by consumers toward savings and self-preservation. Banks will respond to the trend in both product development and reward program evolution, says Marks.

"If frugality is now cool, then the companies that establish themselves as helping you save or be smart will win the hearts of the customers,"

says Marks. First Tennessee's new brand promise, "Powering your dreams," underscores the bank's understanding of this opportunity.

Rubina Havlin, Senior Vice President for Canada's Scotiabank, agrees that product development must continue to mirror customer needs. "We take a holistic customer view of how we approach credit and marketing. Our newest card product, Momentum, complements our branding taglines 'Make the most of what you have' and 'You're richer than you think.'"

Banks have seldom been sympathetic figures, and the perception that rampant greed both fueled the industry and hastened its collapse may find consumers casting a skeptical eye toward the new era of stingier rewards policies. The banks that emerge with stronger customer relationships will be those that transform themselves from partners in consumer profligacy and avarice into partners in consumer savings and responsibility.

"We'll start to see how the value of the banking relationship gets redefined," says Nancy Gordon.

III. Loyalty models redefined

In 2003, COLLOQUY published a white paper, *A New Model for Relationship Banking*, that used the

Banco Popular *Premia* program as the harbinger of a new trend in Total Relationship Banking, in which consumers are rewarded across their entire relationship with their bank. We predicted that more banks would follow the *Premia* model of rewarding loyalty currency for credit, debit, checking and savings accounts, home mortgages and more—and so it came to pass. Citi followed with *ThankYou Rewards* in 2004, and when National City launched *Points* in 2006, it looked like the tipping point was near.

But today, Relationship Banking is, at least temporarily, a non-starter. What happened? In one word, *recession*. The Relationship Banking model is challenging to execute and expensive to operate, and with a myriad of competing priorities in a tough market, most banks are content to keep Relationship Banking on the back burner. Tests continue—for example, First Tennessee Bank piloted a version of Relationship Banking in 2004, and was prepared to roll it out nationally until the mortgage business unit was sold to MetLife.

For now, companies that launched Relationship Banking efforts early will continue to work the model, while others lay low. Banco Popular's *Premia* program continues to report positive results in account acquisition,

cardholder retention, and member profitability. Citi likewise continues to expand its *ThankYou* partner network, as evinced by their alliance with Amazon in December 2008. Despite TARP bailout funds and calls for the breakup of the company, Citi continues to stand behind the program.

"Citi is committed to the program, committed to servicing our customers, and committed to providing *ThankYou* rewards for our members," says Gordon.

One reward model that may continue to proliferate during these troubled times is the merchant-funded rewards model, which first took hold in the industry as an innovative way to provide richer rewards on thin-margin debit card products while sharing expenses with retail partners. The model has proven so appealing to banks, says John Owens, that merchant funded rewards have evolved to be "somewhat commonplace and less of a differentiator." As issuers continue to plan, launch, scale, and retool merchant-funded programs, the challenge will be for loyalty managers to prove that these programs lead to increased loyalty and sustainable cross-sell of retail banking accounts.

Finally, issuers will look to successful models outside the U.S., such as coalition loyalty programs. Successful coalition programs are driven to such a large degree by credit card spend, and issuers can enjoy such a tremendous advantage in terms of shared operational and marketing costs, that a U.S. issuer throwing their hat into the ring to help launch a national U.S. coalition seems like a no-brainer. Where there's a will to innovate, there's a way.

IV. Focus on the database

If loyalty and rewards programs are to play a meaningful role in future financial industry success, then they'll have to evolve to mirror

consumer needs. As transaction volume continues to shift toward debit cards and the purchasing power of the Millennial generation increases, banks will have to face up to new challenges in engaging their customer base.

"The winners will be the ones who change the game," says Dan Marks. "Card companies that shift to more of a mix of rewards and benefits that help customers manage their financial lives better and save more money will win."

To develop this mix, banks will have to become closer partners with their cardholders—and that partnership will be cemented in the database. Customers will tell banks what mix of credit and debit card spending they prefer, how much they want to save, and what combination of cash, merchandise and travel rewards will motivate them. A new era of

The future of loyalty marketing in the financial services industry, then, is essentially a microcosm of the future of industry as a whole—a lot of short-term fear, pain and uncertainty that will eventually give way to a new era of sensible, value-based banking.

personalization and financial partnership will offer a way forward. For their part, Citi has already seen their cardholders and members become more focused on everyday practical rewards and cash at the expense of saving up for big-ticket aspirational items. But Nancy Gordon says success will equally depend on the ability of banks to craft definitions of customer value that reflect the new economic reality.

"As the new economy unfolds, loyalty programs will create additional and more innovative ways to reward customers," says Gordon.

"Real-time offers that are targeted and meaningful to the customers will likely be a new and effective trend," says John Owens. "Getting to that level of loyalty marketing is where the industry will likely go next."

The past recaptured

The future of loyalty marketing in the financial services industry, then, is essentially a microcosm of the future of industry as a whole—a lot of short-term fear, pain and uncertainty that will eventually give way to a new era of sensible, value-based banking. Consumers have sparked to payment card rewards, and the products have historically outperformed non-rewards cards in both spend and profitability. That formula is unlikely to change.

The key to future success depends entirely on the ability of the industry to innovate, place customers in the driver's seat and steer product development toward helping consumers achieve overall financial health. We'll continue to see issuers shift away from acquisition and toward the retention of profitable cardholders through

effective use of cardholder data. For cardholders, this shift will translate to a more favorable reward mix; for issuers, the shift will lead to enhanced strategic partnerships and lower-cost delivery channels. For a meaningful recovery to occur, customers and banks will have to form a real alliance.

"It's a two-sided relationship," says Nancy Gordon. "Both consumers and institutions face challenges in this environment. Striking a balance between the two will be critical to rebuilding those relationships so that when the recovery begins, we can all revel in the good times together." ◀

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